

Top five reasons for rejection of HKEX listing applications – and how to avoid them

Since 2013, the Stock Exchange of Hong Kong Limited (the “**Exchange**”) has been publishing decisions on reasons for rejection of listing applications to provide greater transparency to the market. Prior to that, the Exchange published selected rejection letters or listing decisions, but they did not cover every rejected application. Based on these published letters and decisions, we have quantitatively compiled the top reasons for rejection. These serve as a guidance to listing applicants and sponsors alike on what the real issues are when handling listing applications, and as a more in-depth look at the Exchange’s stance towards certain issues.

Overview

If you are already familiar with the listing decisions or rejection letters you should read this to get an idea of what the most common reasons for rejection are, and may skip the back part where these reasons are explained in more detail.

The charts below reveal that the top reasons for rejection are largely based on rules which give the Exchange relatively wide discretion on the merits of a listing applicant. Figure 1 summarizes the distribution of reasons for rejection stated in all listing decisions, rejection letters or guidance letters which have been published by the Exchange. Figure 2 summarizes the distribution of rejection reasons which are limited to those published since 2013, when the Exchange decided to publish reasons for every rejection.

In both charts, “unsustainable business” and “lack of commercial rationale” are the top reasons for rejection. This can be interpreted as a natural result of the Exchange having issued specific rules and guidance on other aspects of a listing application and requirements for a listing applicant, for example on disclosure requirements and on requirements in relation to an offering. As a result, whenever a listing application is rejected, it is usually a result of the applicant having satisfied most of the other requirements but failing, in the view of the Exchange, or the Listing Committee, to justify that it is suitable for listing. This reflects, as the Exchange has acknowledged, a higher level of scrutiny exercised by the Exchange in its assessment of suitability for listing, and exercise of its discretion to determine whether there are facts and circumstances to form a reasonable basis to believe that an applicant is likely to invite speculative trading upon listing or to be acquired for its listing status in recent years¹.

¹ Listing Decision 121-2019

A quantitative analysis

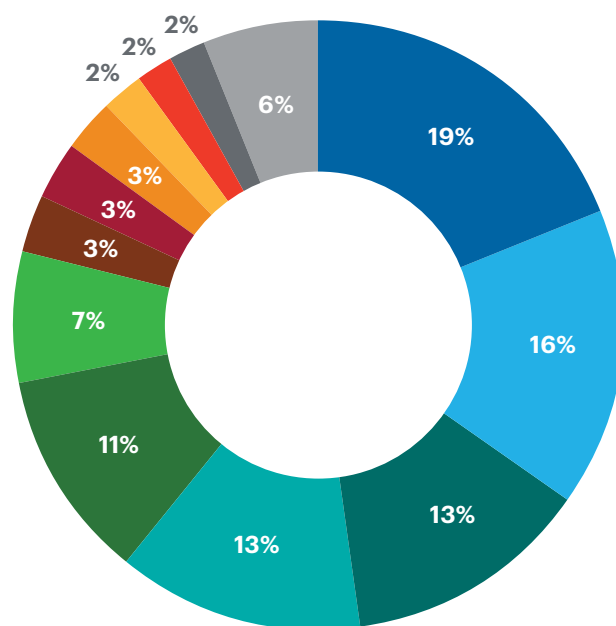
As seen from the charts, the top two reasons for rejection, namely that the business is not sustainable, and that the listing lacks commercial rationale, have taken up a whopping 35% of the rejection reasons since the Exchange started publishing reasons for rejection, and a 40% of all rejections since 2013, when reasons for rejection of every application were published.

Interestingly, the fourth most frequent reason for rejection since 2013 (as shown in Figure 2) is an applicant's failure to demonstrate its ability to meet the minimum profit requirements. It might first seem to be inconceivable since this is usually the first question that an issuer or its advisers would look at before commencing listing application preparations. A detailed review of rejected applications divulges that the Exchange's classification of profits eligible for the profit test has posed certain obstacles to some of the past listing applications, discussion of which is set out in the section headed "Common reasons for rejection of listing applications by the Exchange," below.

We will discuss the top five reasons for rejection in more detail below, but they should not be viewed as the only reasons for rejection. As more listing applications are filed, and some of them will inevitably be rejected, there is no guarantee the reasons stated here are going to be the main reasons for rejection going forward. On the other hand, we state these reasons because they take up a large proportion of the reasons for rejection, and represent, at least for the time being, important issues that sponsors and advisers ought to look into apart from items in their usual checklists. If you suspect any of these reasons may apply to your current listing application(s), you are encouraged to read the relevant listing decisions, guidance letters, or rejection letters in full and seek further guidance from your advisers.

Figure 1

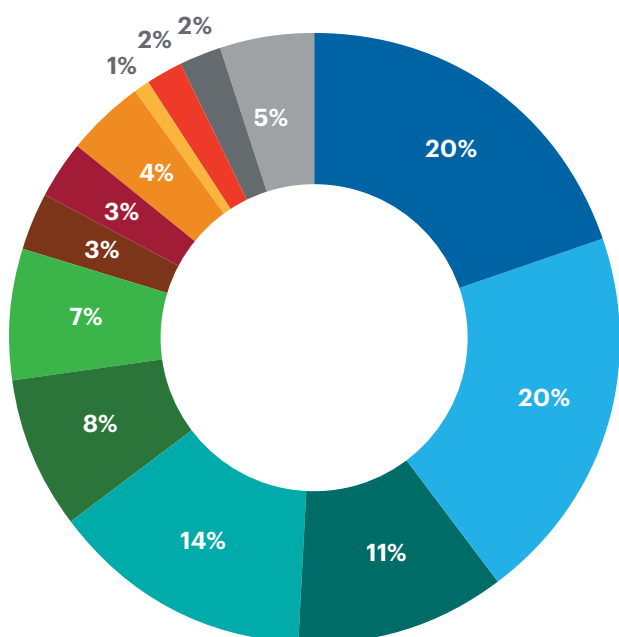
Reasons for rejection shown in all published listing decisions, rejections letters or guidance letters



- Unsustainable business – 19%
- Lack of commercial rationale and thus no genuine funding needs – 16%
- Failure to demonstrate the ability to meet the minimum profit requirements – 13%
- Suitability of director, person of substantial interest or controlling shareholder – 13%
- Over-reliance on controlling shareholders, closely related persons or a single customer – 11%
- Non-compliances – 7%
- Inability to meet the minimum cashflow requirement – 3%
- Unable to comply with ownership continuity and control requirement – 3%
- Unsupported valuation – 3%
- Failure to demonstrate its ability to meet the minimum market capitalisation requirement – 2%
- Failure by the sponsor to satisfy the independent requirement – 2%
- Packaging – 2%
- Others – 6%

Figure 2

Reasons for rejection shown in all published listing decisions since 2013



- Unsustainable business – 20%
- Lack of commercial rationale and thus no genuine funding needs – 20%
- Failure to demonstrate the ability to meet the minimum profit requirements – 11%
- Suitability of director/person of substantial interest or controlling shareholder – 14%
- Over-reliance on controlling shareholders, closely related persons or a single customer – 8%
- Non-compliances – 7%
- Inability to meet the minimum cashflow requirement – 3%
- Unable to comply with ownership continuity and control requirement – 3%
- Unsupported valuation – 4%
- Failure to demonstrate its ability to meet the minimum market capitalisation requirement – 1%
- Failure by the sponsor to satisfy the independent requirement – 2%
- Packaging – 2%
- Others – 5%

Common reasons for rejection of listing applications by the Exchange

No. 5: Over-reliance on controlling shareholder(s), closely related person(s), a customer or a supplier

This reason used to be one of the most feared of and a definite no for listing applicants. Over the years, however, the Exchange has begun to recognize that it is natural for some industry participants to rely on a relatively few number of customers; or to rely on the services or facilities provided by a controlling shareholder, the nature of which can be unequivocally delineated from the business of the applicant.

One example under this category is the Exchange’s rejection of a listing application due to the applicant’s extreme reliance on a major customer who contributed to more than 20%, 60% and 75% of the applicant’s total revenue during the track record period. The reliance was not mutual and complementary, and was unlikely to be reduced after listing². In another listing application, the applicant was rejected because over 90% of its revenue during the track record period was generated from its largest customer, who was not reliant on the applicant. In other words, while the applicant relied on its largest customers for most of its revenue generated, the reliance was not mutual and complementary. Since the applicant lacked experience in selling upgraded products in an evolving technological and regulatory environment, it failed to demonstrate its ability to attract new customers so as to reduce the reliance³. The Exchange has also considered an applicant unsuitable for listing when the applicant heavily relied on its controlling shareholders for financial assistance and client referrals⁴. Heavy reliance on a few business partners to bring in customers whose credits were partly guaranteed by these business parties also led to the rejection of a listing application⁵. Note that the emphasis here is on the likeliness of the reduction of the reliance after listing. If there is a real prospect that such reliance is going to be reduced, and the applicant is already taking measures to reduce the reliance,

² Listing Decision 92-2015, “Company F”
³ Listing Decision 107-2017, “Company J”
⁴ Listing Decision 92-2015, “Company B”
⁵ Listing Decision 92-2015, “Company L”

it may be a mitigating factor for the heavy reliance over the track record period. Examples of such measures include finding new customers and adoption of diversification strategies.

The Exchange will take a number of factors into account in order to determine whether the applicant's material reliance on another party may impinge on its suitability for listing, including (a) whether the relevant party is mutually dependent on the applicant and (b) whether the applicant has a long-term agreement with the relevant party⁶. The applicant and its advisers should carefully examine whether there is any reliance on any controlling shareholder(s), closely related person(s), customer(s) or supplier(s). If so, the applicant should demonstrate that such reliance can be reduced upon listing, and any concerns about its exposure to any material adverse changes to or termination of its relationship with the relevant party can be mitigated.

No. 4: Inability to meet minimum profit requirements

As discussed above, the fourth most common reason for rejection is an applicant's failure to demonstrate the ability to meet the minimum profit requirements for listing. While having sufficient net profit in audited accounts is the basic requirement under Rule 8.05 of Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "**Listing Rules**"), issuers and sponsors should review them in relation to the overall business of the applicant.

Examples under this category include failure to meet minimum net profit requirements after exclusion of non-ordinary course income⁷. The Exchange has also excluded income from sources which may be non-compliant with an important license that the applicant holds⁸. In another case, an applicant was rejected because more than 80% of its net profit came from the fair value gains from investment properties, without which the applicant cannot meet the minimum profit requirement⁹.

Audited accounts should be reviewed critically in conjunction with other metrics such as profit from fair value gains from investment properties or from

non-compliant activities. To avoid rejection under this reason, despite the audited accounts meeting the minimum financial requirements, applicants should seek to minimize the possibility of a good part of the applicant's profit being taken out based on "but for" calculations, which would render the otherwise eligible financials no longer satisfying basic listing requirements under Rule 8.05.

No. 3: Unsuitability of directors, controlling shareholders and/or persons of substantial interest

Although Rule 8.04 of the Listing Rules expressly refers to the suitability of the issuer and its business, it is not surprising that the Exchange is also concerned about non-compliances or misconducts by a director, person of substantial interest and/or controlling shareholder of the applicant, as they are capable of exerting significant influence on the operations and management of applicants and thus affect applicants' suitability for listing.

In one case, the listing application was rejected on suitability grounds since during the track record period, a number of the applicant's directors had been convicted of bribery. In view of such misconduct, the directors were not considered suitable and rendered the applicant unsuitable for listing¹⁰. In another instance, the prior willful tax evasion by a person who is the applicant's controlling shareholder, founder and director, led to the Exchange's rejection of the listing application. It appears that when the misconducts involve dishonesty, which give rise to concerns regarding a person's integrity, the Exchange is more likely to conclude that the person is not suitable to be a director of listing applicant and may reject the listing application on suitability grounds¹¹.

Thorough due diligence should be conducted on directors, controlling shareholders and any persons of substantial interest to unearth any prior non-compliances or misconducts which may impede the applicant's suitability for listing, especially those pertinent to honesty and integrity.

⁶ Guidance Letter 68-13

⁷ Listing Decision 121-2019, "Company I"

⁸ Listing Decision 107-2017, "Company A and Company B"

⁹ Listing Decision 100-2016, "Company E"

¹⁰ Listing Decision 107-2017, "Company L"

¹¹ Listing Decision 121-2019, "Company Q"

For past non-compliances that do not involve dishonesty or are of a less serious nature, it is advisable for the applicant and/ or the person(s) concerned to obtain legal confirmation from the person in question that no further action or consequences would follow.

No. 2: Lack of commercial rationale and thus no genuine funding needs

Whilst a number of factors are taken into account, a greater level of scrutiny is now placed on an applicant's commercial rationale for listing. We will not comment on whether the Exchange should, and if so to what extent, look into the intention of listing, but the lack of commercial rationale for listing and genuine need for funding, which affects the applicant's suitability for listing, has become the second most common reason for rejection in recent years.

The Exchange requires applicants to explain how their application for the initial public offering proceeds makes commercial sense. On a number of occasions, the Exchange has rejected listing applications where the applicants intended to use the proceeds to acquire land or property, but the cost savings derived from owning and leasing the properties were immaterial¹². Another example under this category would be the failure to demonstrate a genuine funding need as the applicants had previously relied upon internally generated funds to finance their operations during the track record period, and did not demonstrate the need for external funding¹³.

The applicant is therefore advised to review its past and future business strategies and observe the industry trends carefully before devising a plan for use of proceeds commensurate with such strategies and trends. Detailed commercial rationale for listing should be explained in the listing document, and generic descriptions such as using listing proceeds (a) to increase reputation and brand awareness, (b) for potential acquisitions without identified target and specific selection criteria, and/or (c) for expansion through increase in headcount, should be avoided¹⁴.

No. 1: Unsustainable business

Finally, the most common reason for rejection is the unsustainability of an applicant's business. While no one can technically predict whether any company, listed or not, will be able to sustain its business, the Exchange looks at a few factors which it considers to be able to affect the sustainability of the business of an applicant.

Examples include: **(a)** how susceptible the applicant's financial performance is to changes beyond its control, **(b)** if there is deteriorating financial performance and the underlying causes of such downward trend; **(c)** any material change that may imminently threaten an applicant's operations; and **(d)** whether the new applicant had demonstrated that it is able to effectively mitigate its exposure to the relevant risks¹⁵.

In one case, the Exchange rejected a listing application where there had been a significant deterioration in the applicant's financial performance during the track record period. Despite the applicant's attempts to turn around the performance, there was insufficient basis for the Exchange to believe that the situation would improve as the applicant's diversification into a new business segment was recent and long-term prospect of the new segment was uncertain¹⁶.

In another listing application, the Exchange considered the applicant's business unsustainable when the applicant experienced a significant decline in its net profit during the track record period which was compounded with the loss of its largest customer due to price competition. There were also concerns that the applicant might face further pricing pressures when attracting new customers and retaining existing customers which would lead to further deterioration of its profitability¹⁷.

The applicant and its advisers should therefore provide a robust and comprehensive analysis in the listing document to substantiate that its business is sustainable, particularly when an applicant (a) has experienced decreasing or low profit and revenue

¹² Listing Decisions 121-2019, "Company J and Company K"

¹³ Listing Decision 121-2019, "Company W" and Listing Decision 119-2018, "Company A"

¹⁴ Guidance Letter 68-13A

¹⁵ Guidance Letter 68-13

¹⁶ Listing Decision 121-2019, "Company A"

¹⁷ Listing Decision 100-2016, "Company G"

growth; and/or (b) is expected to record decreasing or low profit and revenue growth after listing¹⁸. Possible solutions may include diversification of its revenue sources, expansion of its customer base and reduction of costs, or at least a demonstration that such measures are being taken. If there is any material change that may adversely affect the applicant's prospects (such as changes in regulatory requirements and development of new technology which renders its business obsolete), the applicant should affirmatively demonstrate to the Exchange that such changes are unlikely to materialize and will not affect the sustainability of the applicant's business¹⁹.

Conclusion

A common thread among the top reasons for rejection is that the Exchange exercises a relatively wide discretion under Rule 8.04 in considering whether certain applicants are suitable for listing even though all other rules have been complied with. While clear-cut rules and guidance on the more ambiguous rejection reasons are desirable, we understand that the Exchange should have certain discretion to exercise its power in rejecting certain applications and consider them on a case-by-case basis. We hope this guide has given you a general (but not exhaustive) overview of the reasons for rejection and will help sponsors, applicants, and their advisers look into these issues at the early stages of the IPO process or even before kicking off an IPO project.

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¹⁸ Guidance Letter 68-13A

¹⁹ Guidance Letter 68-13